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DELAWARE DECISION REDEFINES RECORD HOLDERS, FOCUSES ON THIRD-PARTY VOTE BUYING CLAIMS AND INVALIDATES BYLAW AMENDMENT REMOVING SITTING DIRECTORS

A February 9, 2010, Delaware Court of Chancery decision has wide-ranging significance for corporate practitioners. In *Kurz v. Holbrook*, C.A. No. 5019-VCL (Del. Ch. Feb. 9, 2010), the Delaware Court of Chancery issued an opinion that (1) revised Delaware law with respect to the definition of “stockholders of record” of a corporation’s stock, (2) subjected the examination of third-party vote buying techniques to equitable review, and (3) examined the validity of bylaw amendments purporting to shorten the terms of sitting directors.

In *Kurz*, Take Back EMAK, LLC (“TBE”) and Crown EMAK Partners, LLC (“Crown”) offered competing consent solicitations for control of EMAK Worldwide, Inc. (“EMAK”). TBE launched a consent solicitation to remove several EMAK directors and fill those and additional vacancies to give TBE majority representation on the EMAK board. Crown countered by launching a consent solicitation to amend EMAK’s bylaws to reduce the number of directors on the EMAK board, thereby removing several sitting directors and inhibiting TBE’s effort to gain control of the EMAK board. TBE was able to obtain consents from enough holders of the EMAK shares (including banks and brokers who held through Cede and Co.) to give TBE voting control, but only after one of its members purchased the voting and economic rights of 150,000 EMAK shares for $1.50 per share at a time when such shares were trading for $1.00 per share. After the inspector of elections invalidated TBE consents representing more than 1,000,000 EMAK shares because TBE had not obtained the Depository Trust Company (“DTC”) omnibus proxy, which authorizes banks and brokers holding through Cede and Co. to vote in accordance with the instructions received from beneficial owners, TBE filed suit, challenging the invalidation of the consents and the validity of Crown’s bylaw amendment. In response, Crown claimed that TBE had improperly purchased the voting and economic rights of the 150,000 EMAK shares.

Ultimately, the court ruled in favor of TBE on all counts. With respect to the invalidation of the consents, the decision in *Kurz* effectively changes the definition of record holder under Delaware law. Under pre-*Kurz* Delaware law, only holders of record on the corporation’s stock ledger were entitled to vote and, as such, record holders were not defined to include DTC participant banks and brokers. The decision revamped Delaware’s interpretation of “stockholders of record” so that the definition now includes banks and brokers listed on DTC’s participant list, otherwise known as the Cede breakdown, as record holders. The court held that the Cede breakdown is part of a corporation’s stock ledger for purposes of determining the stockholders entitled to vote under Section 219(c) of the Delaware General Corporation Law (“DGCL”). This decision aligns Delaware’s definition of record holders with that of federal securities law.

From a practical standpoint, the change in definition is significant because Delaware’s antitakeover and appraisal statutes are predicated on whether a corporation’s shares are listed on a national exchange or held of record by more than 2,000 stockholders. The change in definition effectively increases the number of record holders of a corporation, thereby increasing the number of corporations subject to Section 203 of the DGCL and decreasing the number of transactions where appraisal rights will be available under Section 262 of the DGCL.

In addressing whether TBE's purchase of the 150,000 shares of EMAK stock was proper, the court noted that, although this instance did not involve the use of corporate resources, third-party vote buying presents the potential for disenfranchising stockholders via manipulation of voting rights and, therefore, when third-party vote buying negatively impacts stockholder voting, the court should provide a remedy. The court presented a three-part framework to guide an equitable review analysis of third-party vote buying, positing the following questions: (1) were the practices employed actually disenfranchising; (2) was the arrangement the product of fraud or a disparity of information; and (3) did the transaction create a misalignment between the voting interest and the economic interest of the shares? In this case, the court determined that no circumstances existed under the three above scenarios to find the purchase of the 150,000 EMAK shares improper.

Lastly, the court held Crown's bylaw amendment invalid. A bylaw amendment that eliminates directors by reducing the number of directors sitting on a board or establishes qualifications for directors that would eliminate sitting directors violates Sections 141(b) and 141(k) of the DGCL and is therefore invalid.

An appeal of this decision has been filed with the Delaware Supreme Court.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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